

CHAPTER 8 CORPORATE GOVERNANCE

Introduction. This chapter focuses on how corporations transform inputs of capital and labor to produce outputs of goods and services. It extends the analysis of economic growth factors presented in the first chapter by looking at the efficiency and effectiveness of the firm in an Asia-Pacific context.

Good governance of the firm is key to the success of any economy.¹ It is analyzed here at the strategic and operational levels.

Strategic Effectiveness. The firm's effectiveness is structured by the roles of other institutions that provide capital, labor, and markets. That is, strategic governance includes the way that an economy combines savings and capital with labor policy to achieve economic output.

- Strategic trends in the development of Asia-Pacific firms have been particularly shaped by global capital flows generated by trade and foreign investment and by unique approaches to dealing with labor.

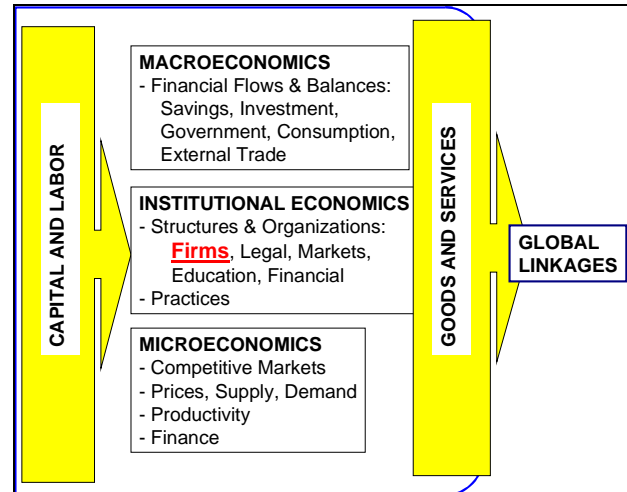
Operational Efficiency. The firm's efficiency depends on all of the business practices that allow it to produce outputs in a cost-effective manner. That is, operational governance includes the way that firms are structured in terms of organization, their dealings and negotiations in the marketplace, and legal aspects of property and bankruptcy.

- The operational governance of Asia-Pacific firms has been strongly influenced by the role of families, cultural styles of bargaining, and the degree of private ownership in Asia-Pacific societies.

Figure 8-A illustrates the important connections that capital and labor have as inputs to an economy that has macro-economic, micro-economic, and institutional-economic dimensions. At the center of this diagram, the firm is a central institution that has connections to other institutions as well as to macro-economic and microeconomic matters.

This chapter first assesses at the strategic level how capital and labor shape the character of Asia-Pacific firms. Then after examining recent corporate trends, it provides illustrations of corporate operational governance. It addresses the roles of corruption and standards in corporate governance, and concludes with observations on the criticality of markets and sound supporting institutions.

Figure 8-A
Economic Analysis Hierarchy



Governance and Globalism

Governance and globalism are intertwined concepts, but have separate foundations.

- Globalism typically refers to the transnational flow of goods and ideas, whereas
- Governance refers to the internal quality and productivity of institutions and their relationship to broader economic and social goals.

Although global trends place stresses on society and the environment, the root cause of a problem often is the style of governance and not the openness to trade or ideas. That is, countries with good governance adapt outside trends; while mismanaged regimes isolate themselves from both internal and external reforms. This internal mismanagement becomes the primary source of broader economic, environmental, and social ills.

Figure 8-B

Strategic Governance of Capital

In many Asia-Pacific countries, selected financial institutions are used to direct large sums of personal savings to firms for economic production. Additional capital is generated from high savings rates that are encouraged by consumption-restricting life styles.

- In Japan, the savings of workers are deposited in postal savings accounts that provide a form of social security for retirement. Japan's banks then direct this capital toward corporate investments.
- In China, worker savings are deposited in government banks, which then re-direct the capital to state-owned enterprises.
- In Singapore, many workers live in small, standard public apartments, which constrict consumer spending and promote savings.

However, poor governance of these financial institutions restricts capital flows to corporations.

- In China, government banks invest in government companies, where decisions often are based on collusion and political connections, rather than economics.

Flows are restricted also by poor macroeconomic policy concerning interest rates. For example, sound corporate investment decisions are based on ranking potential projects by their rate of return and then selecting those whose return exceeds interest rates offered by banks.

- However, Japan has lowered nominal interest rates to very close to zero, so that no careful stratification of projects exists.

Capital Findings. These examples of capital flows suggest there is better governance through:

- A separation of powers between private risk-takers and public enforcers.
- Better governmental oversight of banking and corporate behavior.
- More competition among financial institutions—including families, banks, stock markets, and derivative markets.

Strategic Governance of Labor

The other key source of a firm's input—labor—is driven by governmental institutions that direct education, retirement security, and social policy concerning ethnicity and organized labor.

Education. Many Asian education systems rely on memory skills rather than verbal and analytic skills. In some settings, the questioning of teachers is taken as challenging authority. In modern corporate settings, management and employees are expected to respond to dynamic problems that require constructive interaction and feedback. Asian education systems need to encourage design and communication in place of tradition and authority. That is, students need creative and critical thinking skills, rather than rote learning.

Retirement and Social Safety Nets.

- Japan's larger firms have policies of keeping employees for life, with the expectation that bad cycles can be weathered-out. Of course, the costs of maintaining a disproportionate share of labor inputs are more a matter of social policy than economic efficiency.
- When the IMF called for austerity during the Asian Economic Crisis of 1997, the World Bank issued a call to protect the poor, who were especially hard-hit by increased food and fuel costs. Proposed measures include the creation of unemployment and social security systems similar to those of advanced countries.

Ethnic Factors. A key faultline exposed by the Asian Economic Crisis is that among ethnic groups in Asia, especially regarding the aloofness of business-oriented overseas Chinese from local populations.

- In Indonesia, the economic crisis uncovered a longstanding resentment against wealthier Chinese, resulting in riots. However, some attacks were simply efforts at extortion and did not solely suggest racial animosity.
- In Malaysia and Burma, racial preference programs promote majority groups. However, these programs often become political pawn-pieces for politicians seeking legitimacy among their population.

Organized Labor. Many of Asia's authority-oriented businesses view unions as enemies, rather than as representatives of an often over-looked constituency. The formation of unions helps to promote a multi-dimensional political process. Further, labor's goals of prosperity and increased quality benefit an economy in the form of increased economic demand.

Labor Findings. These examples suggest that better governance of labor can be obtained through:

- Education reform, which can be a key multiplier for economic growth when it promotes creative and critical thinking skills.
- Social institutions, which promote worker's security and social and political stability. Retirement and welfare institutions are weakly developed in the Asia-Pacific region.

Strategic Corporate Trends

The governance of capital and labor as inputs to a firm's production is also illustrated by their trends over the last decade. Many Asia-Pacific firms have combined labor and capital in particular patterns that are undergoing change. These patterns concern the role of the state in directing input flows, the informality of family businesses, and the over-reliance on high quantities of inputs at cheap prices.

Role of the State. As observed in the first chapter, there is no standard template whereby Asia-Pacific governments employ economic policy. In the past, Asia-Pacific governments were unafraid of using government-controlled firms, especially for high capital infrastructure projects such as transportation, telecommunications, and energy.

- Lessons from the World Bank on development are distilled into the rule of thumb that governments should do less in areas where markets can succeed and should do more in areas where markets cannot be relied upon.² That is, government should invest and build in the areas of education, health, poverty reduction, social and legal infrastructure, and macroeconomic security.

- Collusion between government and the firm contaminates a firm's efficiency, especially when profits are redirected to government schemes.
- Across the Asia-Pacific region, collusion of government and corporations is highly correlated to the institution of family firms and paternal oligarchies.

Corporate Transitions. Studies performed by the Asian Development Bank suggest that Asian corporate governance is undergoing a period of transition from informal to formal practices.³

Family Firms. During Asia's phase of rapid economic growth in the 1990s, state and business behavior was based on personal authority, such as that of a family head. In the mid-part of the 1900s business law had been established in Asian countries; however, it was not strongly enforced.

The reliance on personal authority—such as on a handshake when closing a deal—was unchallenged during the prosperous years of the 1990s. Family businesses profited simply by being in a growing sector—the underlying management sciences were ignored.

- However, the tremendous inflow and outflow of capital in the 1990s fractured the ability of government and family business authorities to carefully allocate resources.

Today in Asia, economic laws and institutions are now focusing on legal incorporation, on the role of shareholders, and on the role of contracts.

- Family businesses are merging and incorporating, and revived corporations are professionalizing their management and financial practices.
- These trends towards formal business practices help high-volume investors—both foreign and domestic—who require transparent information about corporate accounting, freedom from fraud, and sound market oversight by the state.

The Producer Model. Another factor shaping the character of the firm in Asia-Pacific economies is the producer-oriented approach used by Japan in the late 1900s. This model focused on using labor that was cheap and plentiful. This approach relied on high

quantities of cheap labor and capital in order to produce industrial and consumer goods, especially for the U.S. market.

- To maintain this approach in the 1980s and 1990s, many of Japan's industries were "hollowed-out" as labor-intensive portions of business were moved to South Korea and Southeast Asia to be produced by less expensive laborers.
- To support this approach, many Asian governments maintained price controls on popular consumables, such as rice and gas, to keep labor costs low.
- A corollary of this model was that laborers should remain cheap and not become consumers.

Quality is Important, Too. However, the long-term viability of this cheap-inputs producer-oriented model is suspect:

- By maximizing volume, firms may ignore market needs, may overbuild capacity, or may waste resources to meet political goals.
- Accustomed to growing markets—and not cyclical markets—producers are unaware of their inefficiencies and learn lessons too late—after demand collapses.
- Decisions on resource-allocation are often directed by ineffective outsiders or uninformed investors, rather than by the efficient methods of open markets.
- Low-wages and low worker standards do not encourage the degree of product innovation and production-line efficiency that are needed to compete in global markets.⁴
- Foreign consumers demand quality in their purchases, which leads firms to using better quality control practices.

The Consumer Model and Diversity. Another trend in the role of firms is that towards consumer-oriented markets. Production for export markets in the 1980s and 1990s generated a new middle-class and a wealthier working class. By the mid-1990s, the countries of Asia were emerging as lucrative consumer markets in and of themselves.

- The diversity of markets in Japan and the United States led to a variety of production sectors in the Asia-Pacific region. This

diversity of economic sectors generated corresponding political interests.

- The source of income and power for these new sectors often was external to traditional political sectors.
- This diversity created middle-classes in Asian exporting countries,
- Whereas the old colonial approaches in Asia focused on exporting single resources and products, the global economy today encourages multiple sources of income and power.
- This diversification corresponds to a trend in political power that is moving away from oligarchies towards democratic faction-building.

Findings on Corporate Trends. To promote stable, self-reinforcing economies connected to global markets, strategic policy needs to promote both producers and consumers.

- Producers need viable markets and sound financial and legal institutions that encourage competition.
- Workers become a key element of the consuming class—adding breadth to economic demand and stability to social processes.
- As consumption and quality of life issues become emphasized, economic security issues become important, such as those addressed in Section Two of this report—energy, commerce, population, and the environment.
- The future path of these economic security issues will be largely determined by the quality of the supporting institutions in each country.

Operational Governance of Corporations

The following illustrations of the internal structure and behavior of Asia-Pacific businesses demonstrate the nuances that make it difficult to resolve corporate problems.

Organizing Through Megacorporations. A common feature across Asia is the creation during the last century of large business organizations that grew through government-assistance and authoritarian management.

- Government construction and trade policies shaped businesses in Japan (called *Zaibatsu*) and Korea (*Chaebol*).
- In the Philippines and Thailand, small groups of authoritarian, family-based businesses captured key markets.
- State-owned enterprises direct several key economic sectors in China, Indonesia, Malaysia, India, Burma, and North Korea.

Culture and Deal-making in Indonesia. Business negotiations in Indonesia have a strong basis in community consultation. Business operations aim to create symbiotic relationships with the surrounding community so that the community feels it has a stake in protecting it. The decision process called *Musyawarah* is based on consultations of neighborhood councils that are overseen by a local law officer and usually result in a consensus drawn up as a communiqué.

- Business decisions therefore incorporate social criteria and are not solely based on microeconomic profitability factors.
- Negotiations are an ongoing interaction with the community, so contracts are often viewed as flexible.
- Indonesia's judiciary was corrupted during the Suharto regime, so neighborhood relations often substitute for formal legal processes and are key to business success.
- At the extreme of this communal process, a seemingly peaceful community may resort to mob-violence.

Ethnic Socialism in Malaysia. In Malaysia during the 1950s and 1960s, community riots against Chinese and Indian merchants led to the *Bumiputra* policy that forcibly integrated Malays into the business world. This affirmative action program created quotas in

education, civil service, and public and private enterprises.

- What ensued was a partnership between Sino-Indian economic powerhouses and Malayan politicians. A shell-game of moving functions between public and private control resulted.
- Provided that there is growth, this small group of people succeed royally.
- However, during economic setbacks, political power brokers deal capriciously with opposition and competition. For example, the Prime Minister's political rival and former economic advisor is now incarcerated—discouraging investors.

Bankruptcy in Indonesia. The Indonesia loan-word *bangkrut* indicates an absence of money and an inability to pay, rather than a legal process to assist creditors in recovering assets. Because power resides with the businessman and his supporting politicians, the economic system is self-defeating in an economic downturn. Although, creditors lose their money, the amateur businessman-politician still keeps his job. As such, bankruptcy reform in Indonesia is a slow, political process.

Pacific Islands Socialism. Property ownership in the Pacific Islands is traditionally a communal right that is controlled by local chiefs. This economically awkward system is circumvented by leasehold procedures; however, long-term investments are difficult.

- This system is compounded in Fiji, where ethnic Indian farmers create agricultural profits that ultimately are controlled by chieftains.
- When island chiefs run government, inflows of aid are directed toward fruitless public jobs rather than productive economic sectors. This economic quandary will be dramatic for the Marshall Islands and the Federated States of Micronesia, where U.S. aid is scheduled for downsizing.

Operational Governance: Corruption

The Problem (in Theory). The equating of corrupt practices with illegal acts that deserve punishment is especially problematic in Asia-Pacific countries. From the point of view of high-level employees, business and government often intertwine personal success and public good. At administrative levels, poorly paid employees may seek the survival of their family through questionable practices. Whether blue-collar or white-collar in nature, corruption becomes a matter for judicial systems when the crime harms economic and social efficiency.

The Problem (in Practice). Two key findings are that corruption levels vary by country and that organized crime is pervasive.

- **Country Variations.** Although subjectively estimated by Transparency International, the depiction of corruption in Figure 8-C sets a foundation for discussing corporate governance and anticipating troublesome countries.⁵
- **Organized Crime.** Present-day Asian criminal organizations, often called Triads, originated during the dispersion of ethnic Chinese over the last few centuries and has since modernized and diversified.⁶ Triads are a key constraint on instituting economic reforms, especially in properly liquidating non-performing loans and in enforcing bankruptcies. Further, they impede the War Against Terrorism through non-transparent banking and money-laundering.

Proposed Solutions to Corruption. Both the U.S. Congress and multilateral institutions such as the Organization for Economic Cooperation and Development (OECD) have renewed longstanding efforts to get multinational corporations to adopt anti-bribery measures. However, the pressures within individual countries to reform their international corporate, banking, and financial institutions have been modest.

Figure 8-C

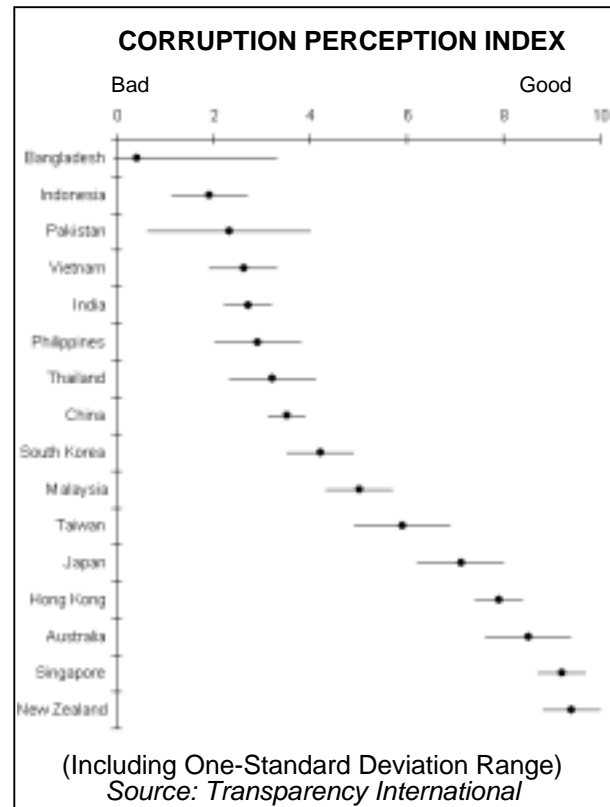


Figure 8-D

Terrorism and Corporate Governance

Organized terrorism can be viewed as a corporation turned neurotic. Its methods are counterproductive and can be used against the perpetrator once he is in power. Nevertheless, terrorist behavior is widespread in the Asia-Pacific region.

- A key constraint in resolving financial and social support to terrorists in Asia is the fluidity, non-transparency, and intransigence of Asian corporate governance styles.
- Organized terrorism is evident in the civil-military clashes in Sri Lanka, the Philippines, and India.
- Maritime piracy in Asian waters also meets the definition of international terrorism in that it is organized, often through Triads, and seeks to harm not only innocent civilians but also to disrupt international commerce.

Operational Governance: Corporate Standards

Besides simplistic exhortations for reform, there are concrete procedures that are available to improve economic efficiency at the firm level. Among these are the implementation of sound standards and policy.

- At the international level, the IMF sponsors codes for institutional transparency of fiscal, financial, and monetary practices.⁷ The Basle Committee for Banking Supervision promotes core banking principles and mutual accords.⁸
- International associations promote specific functions such as securities commissions and insurance regulators, as well as professions such as auditing, accountancy, and international law.
- Complying with international standards is a passport for an entire company to obtain credibility and creditworthiness on an international scale, regardless of problems in their home-country. Originally designed to encourage interchangeable parts, international standards are also published for accounting and engineering by the International Accounting Standards (IAS) and the International Standards Organization (ISO). The ISO-9000 procedure is a rigorous application of industrial engineering practices that improves corporate governance.⁹

At the policy level, a primary objective of any economic policy should be to promote competition, thereby weeding out poor performers and rewarding achievers.

- Participation in the World Trade Organization (WTO) and the International Labor Organization (WLO) promotes healthy competition and accounts for economic externalities like labor, the environment, and social equity.
- While it is controversial to submit to external organizations or standards, the degree of compliance is a good indicator of corporate health, acting as a scorecard similar to those of credit ranking agencies. These schemes create roadmaps for a qualitative improvement in corporate governance.

Conclusion

Taking the Medicine. While prescriptions for healthy economic governance have been available for some time¹⁰, their implementation is difficult due to the unique institutional constraints found in Asia-Pacific countries.

- The history of many Asian states derives from centrally managed governments who find it difficult to relinquish power and enforce market-friendly approaches that encourage diversity and competition.
- Despite kleptomaniac bureaucrats and businessmen, the Asia-Pacific region is undergoing a major evolution of institutions towards mature governance methods.

Markets and Institutions. Not only are free markets necessary, but their effectiveness hinges on building viable supporting institutions. The World Bank presents the following four lessons for success that can be derived from the economic transitions in Asia during the last decade.¹¹

- Complement new structures with existing, local institutions and conditions.
- Promote innovation and experimentations of both public and private forms. When experiments become infeasible, drop them.
- Encourage markets by infrastructures that encourage the flow of information and trade. Restrictions on the press, on trade, or on human rights are counterproductive to economic growth and security.
- While competition is difficult to encourage among those in power, it is a sound formula that increases options, highlights successful people and institutions, and multiplies supply and demand.

Institution-Building. This survey suggests that Asia-Pacific business goals, structures, and behaviors are slowly transitioning from small, exclusive organizations based on authority and the family to larger, competitive organizations based on internal efficiency and market effectiveness.

- This transition is painful, but political and business leaders are realizing that long-term success can only happen through sound business and economic practices.
- The transition will be smoothest for those countries promoting a rule of law that

governs the behavior of business and people alike.

Shock and Reform in the Asia-Pacific Region. The economic takeoff experienced by the Asia-Pacific region in the 1990s was based on a combination of traditional and modern systems that today is being reassessed by people in the region. This reassessment of governance and globalism is the outgrowth of ongoing economic setbacks. The preceding view of corporate governance in the Asia-Pacific region suggests that further development is attainable by building sound economic and social institutions that focus on economic efficiency and effectiveness.

Endnotes

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- 1 World Bank, *World Development Report 2002: Building Institutions for Markets*, 2001 (www.worldbank.org/publications/); and Douglass C. North, *Understanding the Process of Economic Change*, 1999.
 - 2 World Bank, *World Development Report 1991: The Challenge of Development*, 1991.
 - 3 Pistor, Katharina and Wellons, Philip, *The Role of Law and Legal Institutions in Asian Economic Development 1960-1995*; Kahn, Haider, *Corporate Governance of Family Businesses in Asia*; and *Governance in Thailand*. All from ADB 1999. (www.adbi.org/publicat.htm).
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 - 5 Transparency International, *Corruption Perception Index*, (www.transparency.org).
 - 6 Seagrave, Sterling, *Lords of the Rim: The Invisible Empire of the Overseas Chinese*, 1995.
 - 7 These institutions include the Institute for International Finance (IIF, www.iif.org); Bank for International Settlements (BIS, www.bis.org); International Organization of Security Commissions (IOSCO, www.iosco.org); International Association of Insurance Supervisors (IAIS, www.iais.org); International Accounting Standards Committee (IASC, www.iasc.org); International Federation of Accountants (IFAC, www.iafc.org).
 - 8 Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations*, 1999; and *Seeking a Structured Approach to Assessing Corporate Governance Risk in Emerging Markets*, 2001 (www.bis.org/publ/).
 - 9 Regarding industrial engineering, Asia's process redesign efforts take place mainly in global industries like automobiles and electronics, but draw a blank stare among government, service, and financial sector professionals.
 - 10 World Bank, *World Development Report 1991: The Challenge of Development*, 1991.
 - 11 World Bank, *Ibid.*